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A legal update from Dechert's Financial Services Group

CFTC Seeks Comments on Proposed Rules to Set Position Limits in Energy Markets and Change Exemption Available to Swap Dealers

Introduction

Registered investment companies and private funds invest in exchange-traded futures for several reasons, including hedging portfolio risk, creating synthetic positions, providing retail investors with exposure to the commodities markets that would not otherwise be available, and speculating on price movements to generate additional returns for investors. When these funds trade in the futures and options markets—including energy futures and options—they and other exchange traders are subject to regulation by the Commodity Futures Trading Commission ("CFTC") under the Commodity Exchange Act[1] and CFTC rules.[2]

The CFTC places great emphasis on maintaining the integrity of commodity prices on U.S. futures and options markets. As part of an overall market surveillance program, the CFTC uses various tools to monitor trading activity and identify and address manipulative or abusive activity. Two of the CFTC's most powerful tools in this respect are speculative position limits and position accountability rules.[3] U.S. futures and options exchanges set limits on the number of various commodity positions ("position limits") a person or a group of related persons may hold or control. Position limits prevent commodity buyers and sellers from being able to exert undue influence on prices when establishing or liquidating futures or options positions.[4]

Currently, position limits in the four energy commodities traded on the New York Mercantile Exchange ("NYMEX") (collectively, the "Covered Energy Commodities") and in the "look-alike" contracts traded on the

1 7 U.S.C. § 1 *et seq.*

2 17 C.F.R. pt. 1 *et seq.*

3 The CFTC has a third tool by which it monitors daily trading, through its "Large Trader Reporting System" ("LTRS"). The LTRS requires clearing members, futures contract merchants and foreign brokers to file daily reports with the CFTC. These reports indicate whether the commodity futures and options positions held by these reporting firms exceed specific levels set by the CFTC.

4 *Bona fide* hedgers may apply to exceed position limits, whereas the same flexibility is not available to those market participants considered to be speculators. Whether a market participant may qualify as a *bona fide* hedger is a fact-based analysis that may depend on the contracts into which the trader enters and the reasons for that trader's activity on the exchange. The regulatory definition of *bona fide* hedging transactions provides, in part: "transactions or positions in a contract for future delivery on any contract market, or in a commodity option, where such transactions or positions normally represent a substitute for transactions to be made or positions to be taken at a later time in a physical marketing channel, and where they are economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise." 17 C.F.R. pt. 1.3(z)(1).

See also Position Limits and the Hedge Exemption, A Brief Legislative History, Testimony of General Counsel Dan M. Berkovitz, CFTC, July 28, 2009 (discussing how the CFTC has interpreted *bona fide* hedging).

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Intercontinental Exchange ("ICE")[5] are only applicable during the month in which the underlying commodity would be delivered, also known as the "spot month."[6] During other periods in the life of an energy futures contract, these exchanges impose position accountability requirements on traders' buying and selling activity. Under position accountability rules, a holder of contracts in excess of exchange-specified levels must agree to provide information regarding its holdings and investment strategy to the exchange and agree not to increase its holdings if so requested by the exchange.

On January 14, 2010, the CFTC Commissioners voted 4-1 to release for public comment a proposed rule ("Proposed Rule")[7] to set position limits on the Covered Energy Commodities in the all-months-combined and single month periods.[8] The CFTC is proposing the new rule to prevent excessive speculation and excessive concentration of open interest in the futures markets.[9] The Proposed Rule also would establish a new limited risk management exemption for swap dealers available through a transparent application process administered by the CFTC.[10] Currently, swap dealers seeking to enter into exchange-traded futures contracts to offset risk from client-initiated OTC swap positions may receive a *bona fide* hedge exemption to exceed speculative position limits through a confidential application process.[11]

The Proposed Energy Position Limits

The CFTC is using a formula based on open interest[12] for setting the proposed energy position limits, similar to the formula used for agricultural commodities. The CFTC would set position limits in the spot month, single month and all-months-combined as it has with the Federal enumerated commodities[13] and as the exchanges

5 The four referenced energy contracts are NYMEX Henry Hub natural gas, NYMEX light sweet crude oil (aka West Texas Intermediate or WTI), NYMEX New York No. 2 heating oil and NYMEX New York Harbor gasoline blendstock (aka RBOB). In addition to these four specific contracts, the proposed speculative position limits would also apply to look-alike contracts, *i.e.*, "any other contract that is exclusively or partially based on the referenced contracts' commodities and deliverable at locations specified in the proposed regulations." Federal Speculative Position Limits for Referenced Energy Contracts and Associated Regulations, 75 Fed. Reg. 4144, 4152-4153 (proposed Jan. 26, 2010) (to be codified at 17 C.F.R. pts. 1, 20 and 151) [hereinafter Proposed Rule Release].

6 Exchange-traded futures contracts are identified by their underlying commodity and expiration date. For example, Henry Hub natural gas is the underlying commodity for the Henry Hub natural gas contract traded on NYMEX. The spot month is the month in which a trader holding a long contract in Henry Hub natural gas could take delivery of the actual natural gas that comes to market, and a trader holding a short contract could sell the natural gas. Institutional investors such as mutual funds do not hold open interest in the spot month because they do not intend to take physical delivery of an underlying commodity. Instead, they roll their positions forward to another expiration month.

7 Proposed Rule Release, 75 Fed. Reg. at 4144.

8 Henry Hub natural gas contracts expire each month. An institutional investor such as a mutual fund might hold March 2010 contracts, April 2010 contracts and December 2010 contracts. If the CFTC sets a single month limit, that limit would restrict the number of contracts the investor could hold in the individual months of March 2010, April 2010 or December 2010, respectively. An all-months-combined limit would cap how many contracts the investor could hold in March 2010, April 2010 and December 2010 combined.

9 7 U.S.C. § 6a(a). Although the Proposed Rule addresses energy contracts exclusively, the Commissioners have expressed their intent to hold hearings on setting position limits in all contracts for commodities of finite supply, including metals.

10 Swap dealers would apply to the CFTC to be able to manage such dealers' risk arising from client-initiated over-the-counter ("OTC") swaps by entering into offsetting exchange-traded contracts that might exceed speculative position limits. Swap dealers would be required to file a monthly report with the CFTC and document the details of their swaps. The application process would reveal a swap dealer's book to the CFTC. However, during the January 14 open meeting, the CFTC staff indicated that it did not intend to use the application process to look through to the activities of swap dealers' clients, and the application process would not necessarily reveal which clients were speculating and which were hedging. The aim of the application process would be to ensure that swap dealers are not using the risk management exemption for proprietary trading, and to inquire why a swap dealer needs an exemption (considering that the position limits will be set beyond the extent of most market participants' open interest).

11 The *bona fide* hedge exemption would continue to be available to qualifying traders.

12 Open interest is a measure of the "total number of futures contracts long or short in a delivery month or market that has been entered into and not yet offset or fulfilled by delivery." CMEGroup Glossary, http://www.cmegroup.com/tools-information/lookups/glossary/glossary.html (as of Jan. 26, 2010).

13 Federal speculative position limits apply to the following contracts: Corn, Oats, Soybeans, Soybean Oil, Soybean Meal, Chicago Board of Trade Wheat, Hard Red Spring Wheat, Hard Winter Wheat and Cotton No. 2. Position Limits, 17 C.F.R. pt. 150.2.

have with other agricultural commodities.[14] Currently, NYMEX uses position limits in the spot month for the Covered Energy Commodities, but uses position accountability requirements for the single month period and all-months-combined. The formula the CFTC would use for the new position limits is as follows:

- For the all-months-combined limit—10% of the first 25,000 contracts of open interest plus 2.5% of any open interest above 25,000 contracts.
- For the single month limit—66% of the all-months-combined limit.
- For the spot month limit in contracts for physical delivery—25% of the deliverable supply.
- For the spot month limit in contracts that are cash settled—5 times the level fixed for the cash-settled contract's physically-settled counterpart if the trader holds no physically-settled contracts in the spot month. If the trader holds corresponding physically-settled contracts, the limit applies as if the contracts are physically-settled.

Position limits outside of the spot month would apply to a trader's aggregate positions in look-alike contracts across reporting markets.[15]

The Effect of the Proposed Rule on the Markets, Especially on Passive, Long-Only Institutional Investors

During the CFTC's open meeting on January 14 to vote on whether to release the Proposed Rule for public comment, Stephen Sherrod, Acting Director of Surveillance for the CFTC's Division of Market Oversight, presented data that indicated that the Proposed Rule would have affected approximately ten large traders if the Proposed Rule had been in effect on the day of the open meeting. According to Mr. Sherrod, these ten traders would have had control of open interest above the new position limits and would have been unable to qualify for an available exemption. CFTC staff also presented data indicating the limited effect the Proposed Rule would have had on the extensive futures trading conducted by the U.S. Oil Fund and U.S. Natural Gas Fund[16] if the Proposed Rule had been in effect for certain periods in 2008 and 2009 during which each fund's performance peaked. The new position limits would have affected both funds' trading only for a matter of days in each case. On the other hand, had the proposed position limits been in effect from January 5, 2005 to September 19, 2006, the limits would have reined in hedge fund Amaranth Advisor LLC's on-exchange open interest in natural gas, possibly mitigating the effect of the firm's collapse on the natural gas markets.[17] The data CFTC staff presented and Mr. Sherrod's comments suggest that all but the largest funds would be unaffected by the position limits the Proposed Rule would set.

As currently drafted, the Proposed Rule does not single out for different treatment passive, long-only institutional traders such as mutual funds and pension plans. At the time the CFTC held a series of three hearings in the summer of 2009 in anticipation of this proposed rule-making, passive, long-only institutional investors were being blamed for increased energy prices. Critics, such as some end-users of energy commodities, claimed that passive institutional investors, holding the

14 For example, the Chicago Mercantile Exchange has position limits in Lean Hog, Live Cattle and the various Milk contracts. The Chicago Board of Trade has position limits in Rough Rice and Ethanol contracts. ICE has position limits in Coffee, Cocoa and Sugar contracts that trade on its market.

15 *See* Proposed Rule Release, 75 Fed. Reg. at 4147, 4153; CFTC, Proposed Rulemaking Q & A (Jan. 14, 2010), *available at* http://www.cftc.gov/newsroom/cftcevents/2010/oeaevent011410.html.

16 Both the U.S. Oil Fund and U.S. Natural Gas are exchange-traded funds ("ETFs"). These ETFs can be thought of as aggregators of retail and institutional passive investors.

17 Amaranth Advisors LLC ("Amaranth") was a hedge fund that invested in natural gas futures contracts. At one point, Amaranth is said to have controlled more than half of the natural gas trading in the United States. The fund collapsed in September 2006 after losing approximately $6.6 billion in the energy markets as the price of natural gas turned against Amaranth's trading strategy. Although NYMEX and ICE could have used their discretion under the position accountability requirement regime to prevent Amaranth from building such large on-exchange positions beyond position accountability requirements, had position limits been in place, the exchanges and the CFTC would have been obligated to halt Amaranth's activities at lower levels and potentially before the hedge fund's open interest concentration disrupted the natural gas markets. In addition, once NYMEX began instructing Amaranth to reduce its open interest on NYMEX in August 2006, Amaranth moved that trading activity to ICE, without reducing its large overall position in the market. Had aggregate limits across reporting markets been in place, this strategy might not have been available to Amaranth. *See generally*, U.S. Senate Permanent Subcomm. on Investigations, Comm. on Homeland Security and Gov't Affairs, Excessive Speculation in the Natural Gas Market (June 2007); Tina Seeley, *Amaranth to Pay $7.5 Million to Settle U.S. Charges*, Bloomberg News, Aug. 12, 2009; Gretchen Morgenson and Jenny Anderson, *A Hedge Fund's Loss Rattles Nerves*, N.Y. Times, Sept. 19, 2006.

equivalent of numerous "buy" contracts, increased the price of energy to a level unexplained by supply and demand market fundamentals. At the January 14 open meeting, Commissioner Scott O'Malia put the question to the CFTC staff as to whether the staff had enough economic data to conclude that passive, long-only institutional investors' market activity had a negative impact on the markets. Mr. Sherrod noted that since the CFTC's summer hearings, some passive institutional investors had begun staggering their roll process in order to mitigate any potential impact on the markets. However, he was unable to answer Commissioner O'Malia's question regarding whether the CFTC had identified passive, long-only institutional investors' activity in the futures markets as the "smoking gun" that caused the volatility and significant increases in the prices of energy contracts in 2007 and 2008.

However, the fact that the Proposed Rule does not single out passive, long-only institutional investors for more burdensome regulation only tells part of the story. The issue has a history, and potentially a future. Treating institutional passive investors in a similar manner to speculators investing in exchange-traded energy futures is a departure from the CFTC's November 2007 proposed risk management exemption for passive investors investing in commodity indices ("Proposed Risk Management Exemption Rule"). The Proposed Risk Management Exemption Rule would have permitted certain institutional investors to enjoy exemptions from speculative position limits similar to the exemptions for which *bona fide* hedgers are eligible.[18] These passive, long-only investors would have been able to exceed speculative position limits in order to offer their investors exposure to broadly-diversified commodity indices.[19] The CFTC withdrew that proposed rule-making in June 2008, citing "a wide range of divergent positions that have been put forth by interested parties, the current market conditions for the contracts that would be affected by the proposed language, and in order to determine whether further consensus . . . should be sought."[20] In addition, on August 19, 2009, the CFTC rescinded the no-action letters that had provided two institutional investors with relief from Federal agricultural speculative position limits[21] and were the model for the Proposed Risk Management Exemption Rule.[22] Whereas the Proposed Rule does not currently single out these market participants for even more burdensome regulation, the CFTC's rule-making trajectory does not appear as favorable to passive, long-only institutional investors as it did in late 2007.

The Proposed Rule itself raises a series of questions regarding the CFTC's approach to regulating these investors:

- Should the Commission propose regulations to limit the positions of passive long traders?
- If so, what criteria should the Commission employ to identify and define such traders and positions?
- Assuming that passive long traders can properly be identified and defined, how and to what extent should the Commission limit their participation in the futures markets?

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18 Risk Management Exemption from Federal Speculative Position Limits, 72 Fed. Reg. 66,097 (Nov. 27, 2007) (proposed rule) [hereinafter, Proposed Risk Management Exemption Rule].

- The CFTC proposed to exempt futures positions held as part of a broadly diversified portfolio of futures positions based upon either
  - a fiduciary obligation to track a broadly diversified index or
  - a portfolio diversification plan that includes exposure to a broadly-diversified index that includes the same commodity markets in fundamentally the same proportions as the futures position.
- This new risk management exemption would have permitted index funds and other institutional investors seeking to obtain commodities exposure to exceed speculative position limits under certain conditions:
  - the entity would be required to track a "broadly-diversified index;"
  - the position would have to be "passively managed;" and
  - the position would be required to be covered 100% with cash collateral and to be rolled into the next delivery month before the spot month.

19 Investing in commodities can provide diversification in a retail investor's portfolio because commodity markets tend to be negatively correlated or uncorrelated with equities markets. In addition, commodity investing can provide inflation protection to a retail investor's portfolio. Institutional investors such as mutual funds can be considered aggregators of retail investors' passive investment in commodities. Proposed Risk Management Exemption Rule, 72 Fed. Reg. at 66,098.

20 Risk Management Exemption from Federal Speculative Position Limits, 73 Fed. Reg. 32,260, 32,261 (June 6, 2008) (proposed rule withdrawal).

21 DB Commodity Services LLC, CFTC No-Action Letter No. 06-09 (May 5, 2006); CFTC No-Action Letter No. 06-19 (Sept. 6, 2006).

22 Press Release, CFTC Withdraws Two No-Action Letters Granting Relief from Federal Speculative Position Limits on Soybeans, Corn and Wheat Contracts (Aug. 19, 2009), *available at* http://www.cftc.gov/newsroom/generalpressreleases/2009/pr5695-09.html.

- If passive long positions should be limited in the aggregate, would it be feasible for the Commission to apportion market space amongst various traders that wish to establish passive long positions?

- What unintended consequences are likely to result from the Commission's implementation of passive long position limits?[23]

In addition, Commissioner O'Malia requested that passive institutional investors address how the Proposed Rule as currently written would affect these market participants' businesses.

Disagreement Among the Commissioners Regarding the Proposed Rule

The Proposed Rule has engendered dissent among the Commissioners, with Commissioner Jill Sommers voting not to release the Proposed Rule for public comment and Commissioner Michael Dunn emphasizing in his closing remarks at the January 14 open meeting that his vote to go forward with the public release is not an endorsement of the Proposed Rule. Both of these Commissioners have concerns that regulating exchange-traded energy futures will have the perverse effect of pushing trading interest into the OTC swap and international markets where there is less regulation and transparency. Although the Commissioners seem to anticipate that Congress will grant the CFTC jurisdiction to regulate the OTC derivatives markets, Commissioner Sommers has expressed discomfort with regulating the industry piecemeal.

23 Proposed Rule Release, 75 Fed. Reg. at 4163.

The Comment Period

The CFTC announced an unusually long comment period of 90 days,[24] as opposed to the usual 30 days. Given the Commissioners' interest in public comment and the creation of a robust public record before adopting the Proposed Rule, market participants that could be affected by the Proposed Rule may wish to consider submitting a comment letter.

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24 The comment period closes on April 26, 2010. Proposed Rule Release, 75 Fed. Reg. at 4144.

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